John Hardman Moore and contractual incompleteness

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John Hardman Moore outlines his joint research with Oliver Hart, looking at the economics of power and control and the foundations of contractual incompleteness.

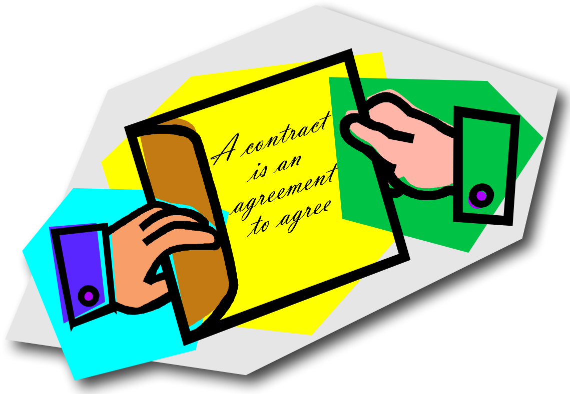

Photo: John Hardman Moore, © SIRE

Hart and Moore (HM) have returned to the primitive questions: ***What is a contract? Why do people write (long-term) contracts?*** The classical view held by economists and lawyers is that a contract provides parties with a set of rights and obligations, and that these rights and obligations are useful, among other things, to encourage long-term investments. HM provide an alternative, and complementary, view. They argue that a contract provides a reference point for the parties' trading relationship: more precisely for their feelings of entitlement. HM develop a model in which a party's ex post performance depends on whether the party gets what he is entitled to relative to the outcomes permitted by the contract. A party who is shortchanged shades on performance, which causes a deadweight loss. One way the parties can reduce this deadweight loss is for them to write an ex ante contract that pins down future outcomes very precisely, and that therefore leaves little room for disagreement and aggrievement. The drawback of such a contract is that it does not allow the parties to adjust the outcome to the state of the world. HM study the trade-off between rigidity and flexibility. Their analysis provides a basis

Another Focus Paper outlines John Hardman Moore's research with Nobu Kiyotaki on the macroeconomic questions to do with the nature of money and liquidity, and the interplay between the financial system and the aggregate economy.

for long-term contracts that don't specify details and throws light on why simple "employment" contracts can be optimal.

In related research, Hart and Moore introduced what they believe is a new way of thinking about contracts. Their idea is that, in an interesting class of cases, the role of a contract is to constrain or circumscribe what people bargain about later, rather than to specify a particular outcome or mechanism for determining that outcome. To put it another way, a contract is an agreement to agree: an agreement to bargain about some things in the future, but not others. The advantage of thinking about a contract this way is that it allows HM to explain why parties restrict their choices, e.g., by taking money off the table. The reason is that sometimes less is more: having less to bargain about ex post can increase ex ante efficiency.



Hart and Moore have also written on the design of hierarchies. Suppose that a decision must be made in an organization. The organization might represent a private firm, a public firm or even society. If two individuals clash over the decision, who gets his or her way? In many cases, the answer is that it depends on who is senior in the organization. That is, there is a hierarchy of individuals with respect to any decision. In the event of a conflict, the decision will be taken by the most senior person in the hierarchy who cares about – or has a view about – this particular decision.

In HM's model of hierarchies, people have ideas about asset usage, but these ideas conflict, i.e., only one person's idea can be implemented with respect to any one asset. HM use their model to analyse the optimal hierarchical structure given that different agents have different tasks; in particular, some agents are engaged in coordination and others in specialization. Inter alia, their theory explains why coordinators should typically be senior to specialists, and why pyramidal hierarchies may be optimal. Their theory also throws light on the optimal degree of decentralization inside a firm and on the boundaries of the firm.